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IN THE

Supreme Court of the United States

OCTOBER TERM, [redacted] 1970

No. [redacted] 160

UNITED STATES OF AMERICA,

Appellant,

v.

MARYLAND SAVINGS-SHARE INSURANCE CORPORATION,

Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MARYLAND

MOTION TO AFFIRM

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INDEX

	PAGE
MOTION TO AFFIRM	1
QUESTIONS PRESENTED	1
STATUTES INVOLVED	2
STATEMENT	3
ARGUMENT	5
I. The Cutoff Date Creates an Unreasonable Classification	6
II. The Cutoff Date Was Properly Excised	10
III. MSSIC Is a State Instrumentality Immune from Taxation	12
IV. MSSIC's Income Is Exempt Under Code Section 115(a)(1)	14
CONCLUSION	15
APPENDIX A	17

TABLE OF CITATIONS

Cases

Brushaber v. Union Pacific Railroad Co., 240 U.S. 1 (1916)	6
Carter v. Carter Coal Co., 298 U.S. 238 (1936)	12
Champlin Refining Co. v. Corporation Commission, 286 U.S. 210 (1932)	12
Department of Employment v. United States, 385 U.S. 355 (1966)	13
Evans v. Gore, 253 U.S. 245 (1920)	8
Galvan v. Press, 347 U.S. 522 (1954)	6
Heiner v. Donnan, 285 U.S. 312 (1932)	7
H. Liebes & Co. v. Commissioner, 90 F. 2d 932 (9th Cir. 1937)	15
Hopkins Federal Savings & Loan Association v. Cleary, 296 U.S. 315 (1935)	7

	PAGE
Madden v. Kentucky, 309 U.S. 83 (1940)	9
Mayflower Farms, Inc. v. Ten Eyck, 297 U.S. 266 (1936)	8, 9
M'Culloch v. Maryland, 17 U.S. (4 Wheat.) 314 (1819)	7
Metcalf v. Mitchell, 269 U.S. 514 (1926)	14
O'Malley v. Woodrough, 307 U.S. 277 (1939)	7, 8
South Carolina v. Wesley, 155 U.S. 542 (1895)	7
Standard Oil Co. of California v. Johnson, 316 U.S. 481 (1942)	13
United States v. Raines, 362 U.S. 17 (1960)	12
Utah Power & Light Co. v. Pfost, 286 U.S. 165 (1932)	12
Yick Wo v. Hopkins, 118 U.S. 356 (1886)	7

Statutes

Internal Revenue Code of 1954 (26 U.S.C.):	
Sec. 115(a)(1)	2, 4, 12, 14, 15
Sec. 501(a)	2, 10
Sec. 501(c)(14)	10
Sec. 501(c)(14)(B)	1, 3, 4, 5, 6, 7, 9, 10, 11, 12, 15
Sec. 501(c)(14)(C)	6
Sec. 7852(a)	12
Revenue Act of 1951, c. 521, 65 Stat. 452	10, 11
Internal Revenue Code of 1939, Sec. 101(4)	11
28 U.S.C. §1252	5
Md. Ann. Code:	
art. 23, §161A(e)	4
art. 23, §§161MM-AAA	3
art. 23, §161NN(c)	4, 12, 13
art. 23, §161-OO	4, 13
art. 23, §161PP	4, 13
art. 23, §161SS	4, 13

PAGE

art. 23, §161WW 4
art. 23, §161XX 4, 13

Miscellaneous

H.R. 3297, 88th Cong., 2d Sess. 7
Treas. Reg. §1.446-1(c)(1)(ii) 15
Md. Const. art. III, §48 12
Report of the Governor's Commission to Study the Establishment of a State System of Insuring Deposits of Savings and Loan Associations 14, 17

IN THE

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OCTOBER TERM, 1969

No. 1575

UNITED STATES OF AMERICA,

Appellant,

v.

MARYLAND SAVINGS-SHARE INSURANCE CORPORATION,

Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MARYLAND

MOTION TO AFFIRM

Appellee moves, pursuant to Rule 16 of the Rules of the Supreme Court of the United States, that the final judgment of the United States District Court for the District of Maryland be affirmed on the ground that the questions presented are so unsubstantial as not to warrant further argument.

QUESTIONS PRESENTED

1. Whether the district court was correct in excising the cutoff date from Section 501(c)(14)(B) of the Internal Revenue Code of 1954 because it created an arbitrary and unreasonable discrimination as applied to Maryland Sav-

ings-Share Insurance Corporation and was, therefore, a denial of its right to due process in contravention of the Fifth Amendment.

2. Whether the district court erred in holding that Maryland Savings-Share Insurance Corporation is not a State instrumentality immune from Federal income taxation.

3. Whether the district court erred in holding that the exemption from Federal income taxation afforded by Section 115(a)(1) of the Internal Revenue Code of 1954 is not applicable to the income of Maryland Savings-Share Insurance Corporation.

STATUTES INVOLVED

INTERNAL REVENUE CODE OF 1954

Sec. 115. Income of states, municipalities, etc.

(a) *General Rule.* — Gross income does not include—

(1) income derived from any public utility or the exercise of any essential governmental function and accruing to a State or Territory, or any political subdivision thereof, or the District of Columbia; or

(2) income accruing to the government of any possession of the United States, or any political subdivision thereof.

* * * * * * *

Sec. 501. Exemption from tax on corporations, certain trusts, etc.

(a) *Exemption from Taxation.* — An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under sections 502, 503, or 504.

* * * * * *

(c) *List of exempt organizations.* — The following organizations are referred to in subsection (a): * * *

(14)(B) Corporations or associations without capital stock organized before September 1, 1957, and operated for mutual purposes and without profit for the purpose of providing reserve funds for, and insurance of shares or deposits in—"

(i) domestic building and loan associations,

(ii) cooperative banks without capital stock organized and operated for mutual purposes and without profit, or

(iii) mutual savings banks not having capital stock represented by shares.

STATEMENT

Maryland Savings-Share Insurance Corporation ("MSSIC") is a non-stock, non-profit corporation specially chartered in 1962 by an Act of the General Assembly of Maryland. Md. Ann. Code art. 23, §§161MM-AAA. MSSIC was the second part of a State program designed to eliminate the patently fraudulent abuses prevalent in the Maryland savings and loan industry in the late 1950's and early 1960's, abuses which resulted in the loss of approximately twenty-five million dollars to shareholders in Maryland savings and loan associations. Its birth was the Maryland legislature's response to a finding of two Executive Commissions that "no existing private corporation . . . could adequately insure the deposits" of savings and loan associations which did not qualify for insurance by the Federal Savings and Loan Insurance Corporation (Jurisdictional Statement, App. A, p. 16).

Membership in MSSIC is limited to associations organized under the laws of Maryland or authorized to do business therein, organized for the purpose of accepting free-share accounts and making loans to their members, and approved by the State Department of Building, Savings and Loan Associations. Md. Ann. Code art. 23, §§161A(e), 161PP, 161WW. It is governed by an eleven member board of directors, three of whom are appointed by the Governor. Md. Ann. Code art. 23, §§161-OO. Its by-laws, rules, and regulations cannot be amended without the prior approval of the Director of the State Department of Building, Savings and Loan Associations. Md. Ann. Code art. 23, §161SS.

All member associations of MSSIC must deposit two percent of their free-share accounts with MSSIC; and these deposits, together with income earned thereon, form the capital of the central insurance fund (Jurisdictional Statement, App. A, p. 16). Such income is exempt from taxation by the State of Maryland, and all of its political subdivisions, and can never be returned to member associations. Md. Ann. Code art. 23, §§161XX, 161NN(c).

MSSIC brought action in the court below to recover $40,898.02 (together with interest) paid by it to the United States Treasury Department, Internal Revenue Service, District Director, Baltimore, Maryland.[1] MSSIC argued below that its income is exempt from taxation under Section 115(a)(1) of the Internal Revenue Code of 1954 (the "Code"); that its income is immune from Federal taxation under the doctrine of intergovernmental tax immunity; and that it is entitled to the exemption from Federal income taxation provided by Code Section 501(c)(14)(B) as a

[1] Taxes were paid by MSSIC between October 6, 1964, and June 1, 1967, in the amounts and for the taxable periods as set forth in Appellant's Jurisdictional Statement, p. 3 n.1.

matter of due process of law (Jurisdictional Statement, App. A, p. 17).

The district court held that the cutoff date in Code Section 501(c)(14)(B) "is arbitrary and a denial of Maryland Savings-Share Insurance Corporation's right to due process", excised the cutoff date from the section, and ordered entry of judgment for MSSIC in the amount of $40,898.02, together with interest as provided by law (Jurisdictional Statement, App. A, p. 35). This is a direct appeal from such decision pursuant to 28 U.S.C. §1252.

ARGUMENT

The decision below is so manifestly correct as not to warrant further argument before it as affirmed. The issue in the case is uniquely narrow; and the decision, if affirmed, would apply only to the Appellee herein.[2] Appellant contends that the rationale of the lower court's decision "draws into question the power of Congress to limit exemptions from tax through the use of 'grandfather clauses,' and otherwise to make tax classifications on the basis of the dates of occurrence of transactions or other events" (Jurisdictional Statement, p. 5).

Appellant's position does not bear scrutiny. The case in no way touches upon the Congressional power to create reasonable classifications by cutoff dates, nor its power to change prospectively the applicability of any provision of the Code. Rather, the only issue is whether Congress is empowered to classify without a reasonable basis. Appellee does not question Congress' vast power to classify

[2] Appellant has admitted that the decision applies only to MSSIC and the North Carolina Savings Corporation. Appellee has no information with respect to this North Carolina corporation; and, therefore, it can not determine whether the lower court's decision is applicable to such corporation.

for tax purposes or to discriminate, if reasonable, between classes of taxpayers. Likewise, the court below recognized that the statute would not violate any concept of due process but for the absence of "any conceivable basis in fact for that discrimination" (Jurisdictional Statement, App. A, p. 34).

Moreover, Appellant cites several sections of the Code containing cutoff dates as indicative of the far-reaching effects of the decision below. However, none of these sections, save one,[3] classify for tax purposes *on the basis of the date of birth of a taxpayer*, as does Code Section 501 (c)(14)(B).

The reasonableness of the classification in Code Section 501(c)(14)(B) alone, and not the power of Congress to make classifications *on the basis of the dates of occurrence of transactions or other events*, has been drawn into question by the court below.

I.

THE CUTOFF DATE CREATES AN UNREASONABLE CLASSIFICATION

Notwithstanding Congress' extraordinary powers granted it by the Sixteenth Amendment, the taxing powers, as all others, are constitutionally limited by substantive due process. See *Galvan v. Press*, 347 U.S. 522, 530 (1954). Thus Congress may not under the guise of its taxing powers create a classification between taxpayers that lacks any reasonable basis. *Brushaber v. Union Pacific Railroad Co.*, 240 U.S. 1, 24-25 (1916). A classification is arbitrary and unreasonable if its only purpose is an impermissible one,

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[3] Code Section 501(c)(14)(C) has a cutoff date identical to the one questioned by the lower court. That section deals with an exemption for corporations similar to MSSIC if created on or before September 1, 1957.

i.e., beyond the scope of Congress' powers. See *Yick Wo v. Hopkins*, 118 U.S. 356, 374 (1886).

The only purpose advanced in support of the classification created by the cutoff date in Section 501(c)(14)(B) is, in essence, the protection of the interests of the Federal Savings and Loan Insurance Corporation ("FSLIC") (Jurisdictional Statement, pp. 9-10).[4] But the direct objective of the cutoff date in furtherance of this alleged purpose is to deter the formation of state mutual insurers. This direct objective alone must support the classification.

While it is Congress' prerogative to protect FSLIC, such protection cannot be achieved by methods beyond the scope of its powers. See *M'Culloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 423 (1819). Congress may not deter the formation of state mutual insurers in order to protect the interests of their federal counterpart. See *Hopkins Federal Savings & Loan Association v. Cleary*, 296 U.S. 315 (1935). Since the only purpose advanced in support of the classification is the protection of FSLIC and since this purpose is an impermissible one, it follows that the cutoff date is "so arbitrary and capricious" that it must "fall within the ban of the due process clause of the Fifth Amendment." *Heiner v. Donnan*, 285 U.S. 312, 330 (1932).

Appellant contends that the district court's holding is inconsistent with this Court's decision in *O'Malley v. Woodrough*, 307 U.S. 277 (1939). That case is not controlling here. In *Woodrough* this Court upheld an income tax on the salaries of all Federal judges taking office after June

[4] Appellant's assertion that protection of FSLIC was the Congressional purpose for classification is based on a statement of the Chairman of the Federal Home Loan Bank Board in hearing before the Senate Committee on Finance on H.R. 3297, 88th Cong., 2d Sess. This statement is not of record in the court below and is, therefore, not properly before this Court. *Cf., South Carolina v. Wesley*, 155 U.S. 542, 544 (1895).

6, 1932, the date of the original enactment of the taxing statute. Congress, however, had a reasonable basis for its classification in that case. Indeed, the classification was constitutionally compelled since this Court had previously held in *Evans v. Gore*, 253 U.S. 245 (1920) that an income tax imposed on the salary of a Federal judge after his taking office was an unconstitutional diminution of his compensation while in office.

This Court's discussion in *Woodrough* that the judge had notice of the tax when he took office relates only to the fact that his salary never decreased while he was in office. *Woodrough* does not represent a judicial sanction of the use of a "grandfather clause" for all possible situations. Rather, this Court recognized the validity of a classification created by a cutoff date when it is supported by a reasonable purpose.[5]

Mayflower Farms, Inc. v. Ten Eyck, 297 U.S. 266 (1936), although involving the equal protection clause of the Fourteenth Amendment, is illustrative of a classification generated by a cutoff date that was found by this Court to be wholly lacking a reasonable basis. Contrary to Appellant's interpretation of *Mayflower* (Jurisdictional Statement, p. 11), the independent milk dealer claiming an unreasonable discrimination did not come into existence until the autumn of 1933, thus *after* the cutoff date of April 10, 1933, had been established by the Milk Control Act of 1933 (its effective date). The 1934 Act, under which the dealer was denied a license, merely re-enacted the original cutoff date. The dealer was denied the license because it had violated the 1933 Act (under which its original license was granted) by taking advantage of the price differential. *Id.* at 270-72.

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[5] Likewise, in every other case upholding a cutoff date cited by Appellant (Jurisdictional Statement, p. 12 n.9), there existed a reasonable basis for the distinction.

Therefore, the dealer, as did MSSIC, came into existence after the cutoff date had been enacted, *a factor not seized upon by this Court to deny relief from an unreasonable classification.* Furthermore, this Court rested its decision not on the fact that the statute would put an existing dealer out of business, but rather upon the fact that it impeded the formation of new independent milk dealers. *Id.* at 273.

The only purpose for the discrimination in *Mayflower* was found by this Court to be unreasonable since it was "but an attempt to give an economic advantage to those engaged in a given business at an arbitrary date as against all those who enter the industry after that date." *Id.* at 274. This Court's discussion of economic advantage there related to the unreasonable nature of the cutoff date in the Milk Control Act and did not purport to represent the only test of reasonableness. However, even were this the exclusive test as Appellant contends, we submit that the standard is met in this case. In *Mayflower*, the economic advantage accruing to dealers in existence at the cutoff date was an opportunity for increased income due to the competitive advantage gained by using the price differential. Likewise, Section 501(c)(14)(B) affords those state mutual insurers organized before September 1, 1957, the economic advantage of increased income because they need not pay income taxes.

Appellee recognizes its burden to negate every conceivable basis which might support the classification created by the cutoff date. *Madden v. Kentucky*, 309 U.S. 83, 88 (1940). Appellee cannot find, nor has Appellant suggested, any conceivable basis, save an unreasonable one, to support this classification. We submit, therefore, that this burden has been satisfied.

II.

THE CUTOFF DATE WAS PROPERLY EXCISED

Appellant contends that the lower court, even if correct in holding that Code Section 501(c)(14)(B) unconstitutionally discriminates against MSSIC, was nonetheless in error in excising only the cutoff date from the statute. Appellant's argument to support this conclusion reveals its fallacy.

Appellant states that the exemption was enacted "only after Congress received assurances that the exemption would be available only to the four mutual insurers then in existence" and that "it regarded the cutoff date as vital" to the enactment of the exemption (Jurisdictional Statement, pp. 8, 13). Therefore, we are told, the cutoff date is inseparable from the statute; and hence the whole section must fall.

The Revenue Act of 1951 eliminated the exemption from income taxation previously afforded the entire savings and loan industry, but retained an exemption for non-profit mutual insurers organized before September 1, 1951 (c. 521, 65 Stat. 452, 490). The legislative history of the 1951 Act discloses *no* reason for the insertion of the cutoff date. Appellant, however, in an attempt to fill this historical void, directs us to a letter written by the Assistant to the Secretary of the Treasury to the Chairman of the Senate Finance Committee nine years after passage of the 1951 Act (Jurisdictional Statement, p. 8 and App. D, pp. 41-43).[6]

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[6] The pertinent portion of the letter from Assistant Secretary Glassman to Senator Byrd, is as follows:

> It has been brought to the Department's attention that the predecessor of Section 501(c)(14) was added to the Revenue Act of 1951 at the behest of two mutual deposit guarantee funds in Massachusetts. Such provision was drafted by counsel for those organizations who state that the 1951 cutoff date was included solely so that it could be represented that the revenue

Initially we note that a statement found in the legislative history of a bill to amend an existing statute should have no probative value in determining the intent of a prior Congress. Especially is this so when the statement relied upon is wholly undocumented and attributable to nothing in the record of proceedings relating to the passage of the 1951 Revenue Act. Moreover, nowhere in the letter can there be found any language indicating that the cutoff date was a prerequisite to enactment of the exemption. Indeed, it appears that the counsel for the Massachusetts funds who drafted the provision gratuitously inserted the cutoff date therein. It is submitted that the legislative history of Section 101(4) of the Internal Revenue Code of 1939 (the predecessor of present Code Section 501(c)(14)(B)) indicates that Congress' primary purpose was to preserve the exemption from taxation for non-profit insurers of shares or deposits in savings and loan associations. What other reason could there have been for Congress to carve out this limited exception from its announced goal of eliminating the exemption theretofore available to the entire savings and loan industry?[7]

Obviously, Congressional intent to limit the exemption to those mutual insurers created before September 1, 1951,

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effects would be limited to the two Massachusetts funds, a fund in Connecticut and one in New Hampshire. The latter fund is no longer in existence.

(Jurisdictional Statement, App. D, p. 42).

[7] Appellant mistakenly states that the 1951 Act was applicable to "existing organizations formed in reliance on the exemption" (Jurisdictional Statement, p. 8). Prior to 1951 all savings and loan associations, *as well as* non-profit insurers thereof, were exempt from taxation. The 1951 Act did not preserve this exemption for all those associations formed prior to 1951, but only for those non-profit *insurers* of savings and loan accounts in existence before that date. Indeed, had the 1951 Act retained an exemption for all savings and loan associations created prior to its effective date, the constitutionality of the Act would have been questioned long before the present action was brought.

if any such intent were present, was subordinate to its clear desire to exempt from taxation generally a small segment of the savings and loan industry, *i.e.*, mutual insurers. A holding that all of Code Section 501(c)(14)(B) must fall would only frustrate this overriding legislative purpose. See Int. Rev. Code of 1954, §7852(a); *Utah Power & Light Co. v. Pfost*, 286 U.S. 165, 184-85 (1932); *Champlin Refining Co. v. Corporation Commission*, 286 U.S. 210, 234-35 (1932); *Carter v. Carter Coal Co.*, 298 U.S. 238, 334-35 (1936).

III.

MSSIC IS A STATE INSTRUMENTALITY IMMUNE FROM TAXATION

Alternatively, Appellee asks this Court to review the lower court's determination that MSSIC's income is neither immune from Federal income taxation nor exempt therefrom pursuant to Code Section 115(a)(1). See *United States v. Raines*, 362 U.S. 17, 27 n.7 (1960).

MSSIC was created by a statutory charter and was designed to effect a marriage between the Maryland government and the private building, savings and loan industry — something that could only be accomplished through a special legislative act. See Md. Const. art. III, §48. It was created to prevent a recurrence of the financial diaster which previously had befallen many of the State's citizens (see p. 3, *supra*, and Jurisdictional Statement, App. A, p. 16).

The charter provides for strict State control of MSSIC's organization and management, thus removing the possibility that the private industry could ever alter its structure at the expense of public investors in member associations.[8] We submit that MSSIC from its very inception

[8] See, *e.g.*, the following sections of MSSIC's Charter: Md. Ann. Code art. 23, §§161NN(c) (investment income can not be returned

was designed to be an instrumentality of the State. Its statutory charter can leave no doubt on this score.

Moreover, available judicial authority amply supports our position. This Court in *Standard Oil Co. of California v. Johnson*, 316 U.S. 481 (1942) and in *Department of Employment v. United States*, 385 U.S. 355 (1966) held that Army post exchanges and the Red Cross, respectively, were instrumentalities of the United States and were, therefore, immune from state taxation. In both cases this Court's determinations rested upon factors present here. MSSIC, like the Red Cross and post exchanges, was created by statute; its governing authority has public representation; and its income belongs to the State, subject to being used for the benefit of investors in State-based savings and loan associations.

Furthermore, Maryland has a direct interest in MSSIC's operations and financial success. Were it not in existence, the investing public would be subject to the same hazards that evoked its creation. Maryland has prohibited MSSIC's income from being returned to member associations and has granted it an exemption from all State taxation. Md. Ann. Code art. 23, §§161NN(c), 161XX. Thus the legislature devised a scheme whereby the Maryland citizenry is assured that monies will be available when necessary. That such monies are not coming from the State's own treasury is immaterial. Had Maryland, for example, created a State agency with which State savings and loan associations not otherwise insured might deposit a percentage of their free-share accounts, the immunity from taxation of income

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to member associations), 161-OO (providing for public members, appointed by the Governor, on the board of directors), 161PP (State agency approval is a prerequisite to MSSIC membership), 161SS (State agency approval of any changes in the by-laws, rules and regulations is required).

earned thereon would be unquestioned. *Cf., Metcalf v. Mitchell*, 269 U.S. 514 (1926). Maryland has done precisely this, but instead through an intermediate governmental corporation, *i.e.*, MSSIC.

The burden imposed upon Maryland by the exaction of the income tax is equally clear. The Maryland General Assembly wanted — indeed demanded — that some provision be made for protection of innocent depositors in savings and loan associations. In lieu of direct State financial assistance, the present system was adopted. MSSIC was created because it was believed that it would provide the required financial security, a belief predicated in part on MSSIC's exemption from Federal income taxation (Plaintiff's Exhibit No. 1, set out in App. A, *infra*, pp. 17-18). Thus, Maryland's attempted discharge of its governmental obligation to protect its citizens' savings accounts would be unduly inhibited by the imposition of the Federal income tax. See *Metcalf v. Mitchell, supra*, at 522-24. We submit, therefore, that MSSIC's income is immune from Federal income taxation.

IV.

MSSIC'S INCOME IS EXEMPT UNDER CODE SECTION 115(a)(1)

If this Court believes, as we think it must, that MSSIC is a State instrumentality, then, *a fortiori*, its income is exempt from taxation under Code Section 115(a)(1).[9] MSSIC's *only* function is essentially governmental in nature. MSSIC's creation resulted from the failure, indeed the fraudulent nature, of the private companies insuring savings and loan accounts prior thereto. These companies facilitated the scheme to defraud Maryland citizens of their

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[9] Section 115(a)(1) exempts "income derived from . . . the exercise of any essential governmental function and accruing to a state. . . ."

savings. Moreover, Congress itself has recognized the need for a governmental institution to insure savings and loan accounts — FSLIC.

To meet the statutory test, therefore, it is necessary only that MSSIC's income *accrue* to the State of Maryland and not that such income be paid into the State Treasury. Since Maryland is vested with the right to the income, such income must be said to accrue to the State. See Treas. Reg. §1.446-1(c)(1)(ii); *H. Liebes & Co. v. Commissioner*, 90 F. 2d 932, 936-37 (9th Cir. 1937). It follows, therefore, that MSSIC's income, if not exempt under Code Section 501 (c)(14)(B), is nonetheless exempt from Federal income taxation pursuant to Code Section 115(a)(1).

CONCLUSION

For the foregoing reasons it is respectfully submitted that the decision of the district court should be affirmed.

Respectfully submitted,

RICHARD W. CASE,
Counsel for Appellee.

Of Counsel:

P. DENNIS BELMAN.

APPENDIX A

PLAINTIFF'S EXHIBIT No. 1

Commission to Study the Establishment of a
State System of Insuring Deposits of
Savings and Loan Associations

Room 809, State Office Building
301 West Preston Street
Baltimore 1, Maryland

February 1, 1962

To His Excellency
J. Millard Tawes
Governor of the State of Maryland

To the Honorable,
The General Assembly of Maryland

In response to Joint Resolution No. 22 of the 1961 General Assembly, this Commission was appointed to study the establishment of a State system of insuring deposits of savings and loan associations in the State and now submits the following report.

In the course of its deliberations, the Commission has met with representatives of the savings and loan industry and has also conferred with officials of the Co-operative Central Bank of Massachusetts and the Ohio Deposit Guarantee Fund, the only organizations which are engaged in a comparable activity.

As a result of its studies, the Commission has reached the following conclusions:

1. That a system for insuring the free-share accounts of State chartered savings and loan associations is desirable and in the public interest.

2. That such insurance should be provided through a central fund financed by the insured associations as is done in Massachusetts and Ohio and that the faith and credit of the State should not be pledged.

3. That all of the sound and well managed Maryland savings and loan associations should be eligible for membership in the fund, but that their participation therein should be voluntary.

4. That the supervision of the participating savings and loan associations by a State regulatory agency is essential.

5. That exemption from Federal income taxation will be essential to the success of any fund for the purpose of insuring free share accounts.

As a result of these findings, this Commission recommends for the consideration of the 1962 General Assembly a bill creating a non-stock, non-profit corporation for the purpose of carrying out these objectives. The Commission has drafted a bill which, in its opinion, will serve this purpose.

DAVID R. COHAN
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